

Internal Revenue Service
memorandum

date: SEP 30 1998

to: Michael J. Coyne, Acting Director
Office of Field Services C:AP:FS

from: ~~Assistant Chief Counsel (Income Tax & Accounting) CC:DOM:IT&A~~

subject: Request for Technical Assistance on the Frivolous Return Penalty

This memorandum responds to your request for guidance regarding the following issues relating to the application of the frivolous return penalty under section 6702 of the Internal Revenue Code ("Code"). Sandy Skelton of your staff explained that the issues arose with respect to a taxpayer of limited income and education who filed a frivolous return after becoming involved with a tax protester group. The revenue officer assigned to the case wanted to abate the frivolous return penalty but was told that, because there is no reasonable cause exception to the penalty, abatement was not possible.

Issues and Conclusions:

(1) Does a taxpayer have the right to appeal the assessment of the section 6702 penalty?

Certain exceptions prevent the taxpayer from appealing the assessment of the section 6702 penalty to the appeals office of the Service. However, after payment of part or all of the penalty, whichever is applicable, the taxpayer can make a claim for refund and, if denied, bring suit in federal district court or the U.S. Court of Federal Claims following the general claim procedures of section 6511 and the general refund suit rules of section 6532.

(2) Can this penalty ever be abated under the reasonable cause "criteria? If not, under what circumstances can the penalty be abated?

There is no reasonable cause exception to the section 6702 penalty. IRM 8(11)(62)2 provides that Examination reviews the claims for refund and when appropriate (emphasis added) abates the penalty. No criteria is given for when it is appropriate to abate.

(3) Do the provisions of section 6703 apply to section 6702?

For returns filed before 1990, section 6703 provides special procedural rules applicable to section 6702 frivolous returns. The section does not apply to returns filed after 1989.

PMTA: 00230

Law:

Section 6702 imposes a \$500 penalty on any individual who files on or after September 4, 1982, what purports to be a return of tax imposed by Subtitle A of the Code, but which (1) does not contain information on which the substantial correctness of self-assessment may be judged or (2) contains information that on its face indicates that the self-assessment is substantially incorrect. For the penalty to apply, the individual's conduct must be due to (1) a position which is frivolous, or (2) a desire (which appears on the purported return) to delay or impede the administration of Federal income tax laws. This penalty is in addition to any other penalty provided by law.

Section 6702 was enacted by the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 96 Stat. 324, in order to deter the rapid growth in deliberate defiance of the tax laws by tax protesters. S. Rep. No. 97-494, Vol 1, 97th Cong., 2d Sess. 277 (1982). The penalty is intended to attack a variety of tax protest activities, including: (1) irregular income tax returns not in processible form because of altered or incorrect descriptions of line items or other provisions; (2) references to spurious constitutional arguments instead of required completion of a tax form; (3) forms on which there is insufficient information to calculate tax liability; (4) presentation of information that is clearly inconsistent, such as the listing of only a few dependents by a person who claims 99 exemptions; (5) "gold standard" or "war tax" deductions; and (6) deliberate use of incorrect tax tables. S. Rep. No. 97-494, supra, at 278.

The section 6702 penalty is not based on tax liability. In addition, there need be no underpayment or understatement of tax in order for the penalty to be imposed. Liability arises immediately with the filing of the frivolous return, and, pursuant to section 6703(b), the deficiency procedures of subchapter 63B do not apply.

For returns filed before 1990, section 6703 provides special procedural rules applicable to section 6702 frivolous returns. Under section 6703, a taxpayer can delay collection action by paying at least 15% of the penalty amount and filing a claim for refund within 30 days after the date on which the Service gave notice and demand for payment. In such cases, the Service is barred from levying or proceeding in court for collection of the remainder of the penalty until 30 days after the claim for refund is denied (or 30 days after the expiration of six months from the filing of the claim, if earlier). This prohibition can be enforced by an injunction from the proper court, notwithstanding the anti-injunction rule of section 7421.

If the claim for refund is denied or the six month period expires, the taxpayer can extend the bar on collection by filing

a petition in federal district court within 30 days. In such cases, the Service cannot collect the balance of the penalty until the proceeding is finally resolved (i.e., when the court decision becomes final).

For tax returns filed after 1989, the 15% payment rule of section 6703 no longer applies to the section 6702 penalty. Thus, taxpayers who want to contest the imposition of the penalty must pay the full penalty before seeking review of its imposition. Repealing the special 15-percent rule places taxpayers who contest this penalty by way of a refund action in the same position as taxpayers who contest the assertion that they owe additional tax to the IRS. H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1399 (1989). If the taxpayer's claim for refund is denied by the Service, the taxpayer may bring suit in federal district court or the U.S. Court of Federal Claims following the general claim procedures of section 6511 and the general refund suit rules of section 6532.

Issues and Discussions:

(1) Does a taxpayer have the right to appeal the assessment of the section 6702 penalty?

IRM 8(11)(62)1 explains that the Examination function is responsible for determining the section 6702 penalty. Once determined, the penalty is assessed and the taxpayer is billed the amount due. After assessment the taxpayer's available courses of action are limited because it appears the penalty is not subject to the Service's postassessment penalty appeal program in spite of the language of IRM 8(11)12.

IRM 8(11)12 states that because returns filed after 1989 no longer fall under the special claim procedures of section 6703(c), the frivolous return penalty is appealable under the postassessment penalty appeal program. However, an examination of the postassessment penalty appeal procedures indicates that this IRM language is incorrect.

The postassessment penalty appeal procedures are discussed in §601.106(a)(1)(iv) of the Statement of Procedural Rules. (On September 20, 1993, the Service issued proposed regulations to clarify, update, and reorder some of the Part 601 regulations. The proposed regulations do not substantively change the regulations sections pertinent to our discussion.) That provision provides that certain chapter 68 penalties (sections 6651-6724) may be appealed after assessment to the Appeals office. The appeal may be made before or after payment of the penalty but before filing a claim for refund. However, pursuant to §601.106(a)(1)(iv)(a) the postassessment appeal procedure does not apply to penalties that are not subject to a reasonable cause or reasonable basis determination. Section 6702 does not provide

for a reasonable cause/reasonable basis exception to the penalty. In addition, IRM 8(11)(61)4 provides that the frivolous return penalty is not subject to a reasonable cause/reasonable basis provision. Thus, we conclude that the section 6702 penalty is not covered by the postassessment appeal program for returns filed after 1989.

For returns filed before 1990, it appears that the postassessment penalty appeal program does not apply to the assessment of the frivolous return penalty for the same reasons described above. In addition, §601.106(a)(1)(iv)(d) specifically excludes the section 6700 penalty for promoting abusive tax shelters from the postassessment program explaining that it does so because section 6700 is subject to the procedural rules of 6703.) Thus, it can be argued that the intent of §601.106(a)(1)(iv)(d) is to exclude from the postassessment program any penalty that has the benefit of the section 6703 rules, including frivolous returns filed before 1990.

For tax returns filed before 1990, a taxpayer can pay at least 15 percent of the frivolous return penalty amount and file a claim for refund within a certain amount of time as explained above. For returns filed after 1989, the 15% payment rule of section 6703 no longer applies. Thus, taxpayers who want to contest the imposition of the penalty must pay the full penalty before filing a claim for refund with the Service. IRM 8(11)(62)2 and IRM 48(13)2-733.1, AIMS, District Office and Service Center Processing Handbook, provide that initial screening of these claims is done by the service center. Examination reviews the claim for refund and when appropriate abates the penalty. If it is determined that the claim is proper, claims originated at the district are forwarded to the district for association with the penalty case file which is held in suspense by district Quality Assurance. Late filed and underpaid claims are disallowed. Pursuant to § 601.106(b) of the regulations, claims are denied if the penalty is protested on moral, religious, political, constitutional, conscientious, or similar grounds. Pursuant to IRM 8(11)(12)1, if the claim for refund is denied, the taxpayer may bring suit in federal district court or the U.S. Court of Federal Claims following the general claim procedures of section 6511 and the general refund suit rules of section 6532. Thus, the taxpayer has the right to appeal to the courts the denial by the Service of a refund claim.

(2) Can this penalty ever be abated under the reasonable cause "criteria? If not, under what circumstances can the penalty be abated?

As discussed above section 6702 does not provide for a reasonable cause/reasonable basis exception to the penalty. In addition, IRM 8(11)(61)4 provides that the frivolous return penalty is not subject to a reasonable cause/reasonable basis

provision. Therefore, it appears that the penalty is not abatable under a reasonable cause exception.

The only reference to abatement of the penalty found in the IRM is at IRM 8(11)(62)2. That subsection provides that Examinations reviews the claims for refund and when appropriate (emphasis added) abates the penalty. No criteria is given for when it is appropriate to abate.

There are several court cases on the frivolous return penalty in which good faith is discussed. In Hoefker v. United States, 86-1 USTC ¶9360 (10/24/85), the taxpayer completed his tax return but failed to sign it because he thought by signing the jurat he was swearing that everything in his return was accurate and complete. The Service imposed the frivolous return penalty, and the court held this was improper because the taxpayer had made a good faith attempt to comply with the tax laws. On the other hand in Knottnerus v. United States, 582 F.Supp. 1572 (E.D.Ill. 1984), the court provided that the taxpayer's state of mind when filing his tax return is not part of the test as to whether the return is frivolous. The taxpayer's good faith in filing the return does not preclude the penalty. The conclusions in Knottnerus have been cited in several other cases. See, Ueckert v. United States, 581 F.Supp. 1262 (D.N.D. 1984), and Cazedessus v. United States, 84-2 USTC ¶9561 (D.Colo. May 23, 1984). Thus, it appears that there is not much judicial support for a good faith defense to the imposition of the frivolous return penalty.

(3) Do the provisions of section 6703 apply to section 6702?

As discussed above, for returns filed before 1990 section 6703 provides special procedural rules applicable to section 6702 frivolous returns. The section does not apply to returns filed after 1989.

If you have any questions concerning this memorandum, please contact Beverly A. Baughman at 622-4940.

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By:

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